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ALTRUSITIC OR PRODUCTION FINANCE?: A DONORS' DILEMMA

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Recently a jaded bank official in Bangladesh told me it was time to give up on cajoling banks to lend to poor people, especially in rural areas. He was discouraged by chronic loan recovery problems--the specialized agricultural bank in the country at the time was collecting less than 20 percent of its loans--and by periodic government announcements of loan forgiveness. Since several large non-governmental organizations (NGOs) in the country had been relatively successful in providing loans to poor people, he argued that all rural lending should be transferred to them.[1] De facto, this transfer has been underway in dozens of countries where traditional development banks and cooperatives have collapsed and where thousands of NGOs are now used increasingly by donors as channels for loans to poor people. Although not announced as such, this is resulting in a shift in donor support from production credit to altruistic lending.

Given this sharp change it may be useful to briefly review why previous approaches often failed to provide sustained financial services to poor people and then go on to speculate on the strengths and limitations of using NGOs instead.

Production Credit

For more than four decades donors employed credit programs in low-income countries to stimulate production, investment, and use of modern inputs, with many of these efforts focusing initially on farmers . Cooperatives, supervised credit programs, private rural banks, and specialized development banks were large parts of this. Government sponsored loan guarantees, concessionary funds from central banks, and bank lending quotas were also elements of many programs. Donors commonly supported these efforts by placing funds in central banks that were on-lent through concessionary credit lines. Although production considerations were the primary objective of these efforts, altruism was often a secondary objective; numerous credit programs targeted small farmers, for example (Donald 1976; Sacay and others 1986). Unfortunately, many of the cooperatives that once provided loans to farmers have disappeared, most of the supervised credit programs for farmers have evaporated, numerous rural private banks have collapsed, many specialized agricultural development banks have imploded, and most efforts to force commercial

[1] In the early 1990s there were more than 800 registered NGOs in Bangladesh with about 140 of them pursuing development objectives. Many of the development NGOs offered financial services. Even small countries such as Bolivia and Gambia typically have a hundred or more developmental NGOs.

banks to lend in rural areas yielded transitory results. A number of factors combined to undermine these production-credit efforts, the following being the most important:

(1) Hostile macroeconomic environments often dampened loan demand, lessened the creditworthiness of potential borrowers, weakened the ability of borrowers to repay loans, and lessened the capacity of many people to save. The weight of this bore most heavily on poor people.

(2) Repressive macro-financial policies also constrained the expansion of formal financial markets. Interest rate controls, hefty bank reserve requirements, and extensive loan targeting lowered the revenues of formal financial intermediaries and boosted their costs. This discouraged them from seeking new clients and from handling small transactions.

(3) Numerous countries operated centrally planned economies that severely crimped the opportunities for small private enterprises which are typically operated by people of modest means, thus limiting their creditworthy demand for formal loans. Central planning was accompanied by an inflexible banking system that performed mostly fiscal functions, rather than financial intermediation, thereby constraining the supply of loans for poor people.[2]

(4) In many cases loans were part of a package of inputs and there was little attention given to the effect credit projects had on the performance of financial intermediaries. Even less attention was given to how credit projects affected the ability and willingness of financial systems to offer deposit services to large numbers of people. These projects were typically evaluated on the basis of changes in the income of borrowers, in production, in use of inputs, in the pace of technological change, in employment, or in investments.[3] In many cases donors and governments used financial markets as a commons and there was little explicit concern given to enhancing their durability.

(5) Donors and governments inadvertently warped formal financial markets by providing concessionary lines of credit (Vogel 1984). It was often cheaper for banks and cooperatives to obtain funds from a central lending source than it was to mobilize private deposits. This resulted in relatively few poor people having attractive places to deposit their savings; in numerous cases donor-nurtured development banks and cooperatives ignored potential depositors, most of whom were relatively poor.

(6) Many governments used financial markets to allocate grants by imposing negative real rates of interest on both loans and deposits, by occasionally forgiving loans, and by tolerating

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[2]Centrally planned economies such as the former Soviet Union and the Peoples' Republic of China, however, generally provided savers of small amounts attractive deposit opportunities until inflation increased in the late 1980s and early 1990s.

[3]For a recent statement of this see World Bank 1993.

hefty loan defaults. This attracted rent seekers who colonized credit programs to the exclusion of poor people.[4] These rents attracted bank employees, the military, the politically influential, and government officials.[5]

(7) Because governments and donors provided most of the funds for lending, political influence permeated the operations of many of these lenders. Bank managers were often political appointees rather than bankers, the organizations were usually overstaffed, and political considerations commonly overroad prudent lending decisions. This resulted in excessive lending costs and in flawed screening of loan applicants for creditworthiness.

The net results of many of these efforts were institutions that could not endure without continual subsidies and financial systems that were allergic to poor people. When donors and governments grew weary of continual calls for more subsidies and withdrew their support, many donor-addicted organizations imploded.[6] Using Von Pischke's metaphor, the formal financial frontier expanded too little, despite massive efforts by donors to extend these frontiers. Many of the credit initiatives were unsustainable and became transient salients in these frontiers. This led major donors such as the World Bank, the Agency for International Development, and the Inter-American Development Bank in the late 1980s to reduce substantially their funding for production credit projects and to increasingly court NGOs.[7] These activities now include much more emphasis on expanding financial services for women and for operators of microenterprises

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[4]Financial markets have a high propensity to distribute subsidies and grants regressively. Interest rate subsidies and the grants realized by absconding with loans are both proportional to loan size: large loan, large subsidy; small loan, small subsidy; and no loan, no subsidy. Tilting these subsidies in favor of the poor further discourages financial intermediaries from lending to poor people by adding to the high costs per-unit-of-money-lent associated with making small loans. Ubiquitous low interest rates on loans resulted in even lower interest rates being paid on deposits and this penalized poor people because they had relatively few alternatives for holding their savings.

[5]A blatant example of this occurred in inflation-racked Sudan several years ago when employees of the agricultural bank received most of the zero-interest-rate loans make by the bank, ostensibly for charity purposes.

[6]Illustrative examples are the Agricultural Development Bank in Bolivia, the Jamaican Development Bank, many of the CNCAs in West Africa, the Cooperative Bank of Uganda, the FIRA system in Mexico, the directed credit programs of credit unions in Latin America, hundreds of rural private banks in the Philippines, the BIMAS program in Indonesia, credit activities in the Comilla project in Bangladesh, and lending through many agricultural cooperatives in India.

[7]An Operation Directive (No. 8.30) issued in the early 1990s sharply reduced the World Bank's traditional agricultural credit activities. It mandated that credit projects must stress improving the performance of financial markets.

through semi-formal lenders. It is still an open question, however, whether or not these more explicitly altruistic credit programs will be any more effective in reaching poor people than were earlier production-credit efforts.

Recent Changes

In an increasing number of countries economic environments are now much more hospitably for financial markets than was the case earlier, largely due to recognition of the failure of previously used strategies, reinforced by donor and International Monetary Fund proddings. Exchange rates are less distorted, interest rates are closer to market rates, product and input prices are more liberated, central planning has been lessened, and private enterprise is allowed to play a larger role in most economies. This has resulted in less inflation, real rates of interest that are generally positive, more economic opportunities for small businesses, and less indirect taxing of agriculture and of other enterprises commonly populated by poor people.

Although history cannot be replayed, it would be interesting to see how the credit projects of the 1970s and 1980s would have fared in the more hospitable economic environments of the 1990s in countries such as Argentina, Chile, China, Egypt, Ghana, Mexico, Indonesia, and Uganda. One might argue that there would have been fewer credit projects; some of the problems that previous credit projects attempted to treat may have been less severe and merited less attention. Would loan recovery have been higher? Most certainly. Would a larger number of people and firms--particularly small firms--have qualified as creditworthy? Most likely. Would a much larger number of people have had the capacity and incentive to place more of their savings in financial institutions? With little doubt. Would rent seekers have had incentives to colonize subsidized credit programs that had no rents? Of course not. Would many of the financial institutions involved have been so seriously undermined? Probably not. Would most of the financial institutions involved in development efforts have become addicted to government or donor funding? Highly unlikely. Would the formal financial frontier in many low-income countries have enveloped a much larger number of poor people? Without a doubt.

Although I feel loans are weak instruments for prodding development, I am convinced that durable financial systems are critical infrastructure in market-driven economies. How else can resource be efficiently reallocated among surplus and deficit units? I am particularly pleased with the new policies of the World Bank that focus on strengthening financial markets, instead of pushing targeted and subsidized credit. Because of major changes in macroeconomic and macrofinance environments the results of finance programs in the future will likely be more satisfactory than was the case in the past. Because of this I am uneasy with the current donor fad that involves abandoning production credit and focusing instead on altruistic lending through NGOs.

The Altruistic Approach

Most societies have norms that warn against incurring debt. It is jarring, therefore, to hear spokespersons for disadvantaged people arguing that credit (debt) is an entitlement for poor individuals. The metamorphose of the negative word "debt" into the positive term "credit" puzzles me, much as does the conversion of an ugly caterpillar into a lovely butterfly. Evil moneylenders are thought to impose debt on their supposed victims by extending loans, but when laced with altruism and done with tender loving care by NGOs this act is transformed into granting credit to beneficiaries. Strangely, the morality of the act is defined by the intentions of the lender. If lenders are concerned about recovering the funds they lend and making a living from doing so, it is termed evil. If the lender is using someone else's money, doesn't worry much about recovering loans, and must continually seek outside subsidies, it is termed good. The fact that moneylenders usually provide sustained financial services to their clients, while altruistic credit activities are often transitory--depending on the depths of the patron's pockets--seldom enters the discussion. Also ignored is the fact that managers of most NGOs sustain a much higher standard of living than does the average, much maligned moneylender. Capturing some of the subsidy that passed through an NGO via attractive salaries, superior transportation, plush offices, and foreign travel is seen as part of doing good.

The term NGO covers a variety of organizations whose objectives range from social to developmental (Bowden 1990). Here, I focus only on the increasing number of NGOs that are involved in extending loans or mobilizing deposits, often at the behest of donors. Many of the NGOs that currently provide semi-formal financial services were established with altruistic objectives. In some cases, financial services were later added to on-going altruistic NGOs, while in other cases NGOs were set up initially to be retail outlets for donor or government funds. Some of the best NGOs are indigenous while many of the weakest were spawned by donor or government funding. Most credit activities in these organizations rest on similar assumptions: that credit is a powerful antidote for poverty, that most poor people have a credit need, and that NGO managers are the only ones who care enough to lend to poor people.

Let me pause for a disclaimer: I admire the work and dedication of a few NGOs that provide financial services and I hope that a few additional NGOs will evolve into similarly admirable organizations. Nevertheless, a much larger number of NGOs, in my opinion, have little chance to grown into efficient organizations. Many pseudo-NGOs are managed by displaced government officials, are connected to life-support systems irrigated by government or donor funds, have only a few hundred beneficiaries, and are high-cost operations in terms of services rendered. In trying to winnow the wheat from the chaff in NGOs, it may be useful to briefly summarize their main strengths and limitations in providing financial services.

Strengths

The main strength of NGOs is they are generally grassroots organizations that are working with poor people. The fact that these organizations are private operations, that they harness the energy of local people, and that some of them are indigenous further enhances their attractiveness. Clearly, a few of these NGOs have been able to fill important niches in existing financial markets: credit unions are effectively mobilizing deposits in many countries, the Grameen Bank providing loans to poor women in Bangladesh, ACCION International helping operators of small businesses access loans in Latin America, and ACORD providing financial services under adverse conditions in several African countries (Abugre 1994). The fact that many developmental NGOs are driven by altruistic motives further enhances their attractiveness in the eyes of donors with similar benevolent objectives.

Limitations

When it comes to providing financial services, NGOs have several inherent limitations. Because of their hands-on approach to development many of them are high-cost lenders. Numerous NGOs lend to less than a thousand beneficiaries and it will be difficult for most of them to realize scale economies because of their small size.

Even more importantly, because they operate mostly outside the formal financial system, prudential regulation and supervision are almost totally absent in NGOs. This is not a significant problem until NGOs begin to mobilize deposits--unfortunately, few people care if donor funds are carelessly lent. Allowing such deposit mobilization without effective prudential regulation, in my opinion, is unconscionable. Poor depositors are unable to assemble the information needed to assess the financial operations of NGOs and thus individually protect their deposits from malfeasance. Donors should be more interested in protecting the interests of depositors through prudential regulation and deposit guarantees than they are about filling the supposed credits needs of a much smaller number of people.[8] Without proper supervision and regulation NGOs will be unable to realize economies-of-scope where the same facilities can be used to produce two financial services--loans and deposits--more efficiently than if it only produced one service. This deposit-mobilizing handicap will also cripple the ability of NGOs to expand lending and largely restrict them to the largess of donors and government, thus further crimping their ability to realize economies-of-scale.

This handicap will further cripple the ability of NGOs to screen loan applicants for creditworthiness based on their saving record and also constrict the outreach of NGO's financial services. The altruistic culture of many NGOs, and the fact that they are largely using donor funds compounds the problems of screening applicants for creditworthiness. If the distinction between a loan and a grant is fuzzy in the minds of the altruistic lender, "loans" will likely be more clearly seen by beneficiaries as grants. Beneficiaries may be willing to repay loans from an NGO as long as the volume of lending is expanding and expectations are that additional loans will be available. Loan recovery problems tend to become more severe when the volume of loans stagnates, possibly due to donor fatigue.

[8]The highly successful Units program in the Bank Rakyat in Indonesia has about six depositors for each borrower.

Chaves has also stressed the limitations of NGOs regarding internal incentives. These organizations, particularly those that use the cooperative form, have ill defined ownership. Altruistic institutions may also have vague standards of performance that are incompatible with procedures that screen loans on the basis of creditworthiness. Organizations that are not disciplined by market forces and profits may act in ways that are in the best interest of the employees and managers of the NGO, rather than in the best interests of the donor or the so-called beneficiaries.

Because of their size, most NGOs have a difficult time diversifying their loan portfolio to manage risk. Many of them are also highly dependent on surges of external funding that compounds management difficulties. Loan recovery problems and relatively high costs, combined with altruism, make it difficult for NGOs to cover their costs of operation from loan revenues. This will subject them to the whims and fads of donors and force them to continually seek subsidies. Many NGOs also lack standard connections to other financial intermediaries and are, therefore, unable to systematically borrow or lend funds through broader financial networks. This will limit their ability to mature into more comprehensive financial markets that can intermediate over large geographic areas.

I am particularly concerned about the ultra-altruistic NGOs that one finds operating in countries such as Bangladesh, Bolivia, Gambia, and Uganda. These organizations are typically small, depend entirely on the beneficence of donors, and compete aggressively for new clients by offering soft loans at low or no interest. Their activities undermine the efforts of more serious NGOs. Their corporate cultures make it virtually impossible to avoid dispensing grants (Boulding 1981).

Conclusions

Providing formal or semi-formal financial services to poor people, especially in rural areas, is expensive. It is not surprising, therefore, that expanding the formal financial frontier to encompass these individuals has been difficult. Nor is it surprising that many fledgling financial institutions have broken their backs while temporarily providing these services. NGOs face the same harsh economic realities.

Although I'm disappointed with the past performance of production-credit projects, and am fully supportive of extending more financial services to poor people, I fear altruistic lending through NGOs is not an effective response. Most poor people want better opportunities to save and ways to enhance their creditworthiness; a much smaller number of poor people are creditworthy. Babbling on about filling credit needs obscures these important facts. Because of their non-regulated nature, NGOs are usually ill equipped to provide secure deposit services. It is one thing to allow NGOs to do good with other peoples' money through slipshod lending, but it is something quite different to promote unsafe deposit mobilization by such organizations. Instead of stressing altruistic lending through NGOs, or going back to production credit, donors should emphasize rebuilding and expanding formal financial infrastructure; the economic environment for doing so is much improved in many countries.

Instead of using NGOs, a much larger number of poor people might be reached relatively quickly through reformed formal financial institutions--especially on the deposit side. In Egypt, for example, a large agricultural development bank has about 1,000 offices located in most rural towns and villages. In a relatively short period of time, and with only modest changes in its corporate culture, the bank could provide deposit services to millions of additional poor people, particularly women. With a slightly revised mission statement and modified employee incentives it could find hundreds of thousands of creditworthy borrowers of small amounts who are increasingly involved in non-farm businesses in rural areas. Buttressed by appropriate donor and government support, these activities could be both profitable and durable.[9]

When it comes to developing durable formal financial systems that are more friendly to poor people, donors must alter their traditional money-driven approach. They must focus far less on moving large amounts of money which often gets in the way of deposit mobilization and concentrate more on reforming financial institutions into more efficient organizations. Major donors must play an important role in these reforms. Many of the financial institutions that might extend more financial services to poor people are hostages of special interest groups or continue to operate under mission statements that are out-of-step with new economic conditions. Many of the traditional agricultural development banks, for example, behave like a division of a ministry of agriculture, rather than as a bank. They are often managed by agricultural technicians rather than bankers, have weak ties to the rest of the banking community, and have directors who know little about banking. In other cases, extremely high reserve requirements and other banking regulations provide strong disincentives for banks to mobilize deposits, especially from poor people. Donors can be instrumental in encourage appropriate changes in these areas.

In assisting with these reforms, donors face a dilemma. Credit projects that pursue either production or altruistic objective directly--something that is politically popular to do--will yield disappointing results for basically the same reasons: both approaches cause financial markets to function less efficiently and to reach few poor people. Financial-market development projects that pursue neither objective directly--something that is politically unpopular--will likely go much further in achieving both production and altruistic objectives.

[9]The Bank Rakyat's experience in Indonesia with reforming traditional production/altruistic lending reinforces this conclusion (Patten and Rosengard 1991). Earlier experience in Japan, Korea, and Taiwan showed that relatively poor people desire deposit services, that many of them can become creditworthy, and that serving these client can be profitable for financial institutions (Kato 1985; Saeki 1947).

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